

POLICY RECOMMENDATIONS TO PROTECT AND GROW
THE COMMUNITY BANKING SECTOR

by
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ABSTRACT

The banking industry has contracted from over 18,000 institutions in the 1980s to just over six thousand banks today. Since 98 percent of banks have fewer than \$10 billion in assets the overwhelming majority of industry consolidation is concentrated in the community banking sector. Research shows that while some of the decline can be attributed to bank failures, the majority of it is due to the collapse of new bank formation. In order to slow the decline of the community banking sector and attempt to replenish the “stock” of community banks lost to failure and consolidation, policymakers should consider taking several steps to relieve community banks from some of the more burdensome regulations that impair their ability to lend. Additionally, policymakers should encourage the Federal Deposit Insurance Corporation to ease some of their requirements in order to charter a *de novo* bank.

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Decision Memo

To: President & CEO,
Independent Community Bankers of America
From: Aaron Stetter
Re: Policy Recommendations to Protect and Grow
the Community Banking Sector

Action-Forcing Event

According to a recent *American Banker* article, the banking industry has contracted from over 18,000 institutions in the 1980s to just over 6,400 in the first quarter of 2015. Since 98 percent of banks have fewer than \$10 billion in assets* the overwhelming majority of industry consolidation is concentrated in the community banking sector.¹ Furthermore, some predict industry consolidation to continue into 2016 and beyond. According to one analyst, “Industry conditions continue to indicate that consolidation is inevitable.”²

Statement of the Problem

If the community banking sector continues to consolidate and lose market share at the current rate and if there continues to be a lack of new entrants to replenish the “stock” of community banks lost to failure or merger, many individual borrowers, farmers and small businesses will be harmed as they search to replicate the lending expertise of the community banking sector. According to a recent study on the future of community banking:

* For purposes of this paper community banks are defined as banks below \$10 billion in assets unless noted otherwise.

¹ Victoria Finkle, “Is Dodd-Frank Really Killing Community Banks?” *American Banker*, August 18, 2015.

² Jeff Bater, “Small, Midsize Bank Consolidation Will Continue, M&A Advisor Says,” *Bloomberg BNA*, January 27, 2016.

Our assessment of Federal Deposit Insurance Corporation data finds that community banks service a disproportionately large amount of key segments of the U.S. commercial bank lending market – specifically, agriculture, residential mortgage, and small business loans. However, community banks’ share of U.S. banking assets and lending markets has fallen from 40 percent in 1994 to around 20 percent today.³

Research from the Federal Reserve Bank of Dallas shows that banks below \$10 billion in assets have seen their market share decrease over a twenty-year time period. Community banks accounted for 64 percent of \$4.6 trillion in banking assets in 1992. By 2015, their market share dropped to 19 percent of \$15.9 trillion in total assets.⁴ This is crucial as agriculture, residential mortgage and small business lending calls for lenders with particular localized knowledge and expertise of agricultural and mortgage markets, commodity prices, local economies and business cycles to make prudent loans while also maintaining maximum flexibility for the borrower.

Community banks play a key role in residential real estate lending as they make up nearly 16 percent of the mortgage market.⁵ In 2013, the default rates of loans secured by one-to-four-family residential properties ran at 3.47 percent for banks with \$1 billion or less in assets versus 10.42 percent for banks with more than \$1 billion in assets. Furthermore, portfolio default rates for residential mortgages held by community banks ran at 0.20 percent versus 1.64 percent overall from 2003–2012 demonstrating

³ Marshall Lux & Robert Greene, “The State and Fate of Community Banking,” Harvard Kennedy School, February 2015, pg. 1.

⁴ Federal Reserve Bank of Dallas, “Too Small to Succeed?—Community Banks in a New Regulatory Environment,” Financial Insights, Volume 4, Issue 4, December 31, 2015, pg. 1.

⁵ Tanya D. Marsh & Josh W. Norman, “The Impact of Dodd-Frank on Community Banks,” American Enterprise Institute, May 2013, pg. 14.

community banks' ability to match their customers with residential mortgage products that work best for them as opposed to one-size-fits-all products offered by competitors.⁶

In regards to small business lending, the ability of the community banking sector to rely on “soft information” such as preexisting relationships or reputation, allow them to tailor loans for borrowers with irregular income or a lack of audited financial statements or financial data. According to a recent study, “Small-business lending, in particular, is one area in which small banks can competitively distinguish themselves by utilizing nonstandardized information gathered in the course of a long banking relationship.”⁷ This rationale is particularly true in rural America. According to a recent study on small business lending in rural areas:

Ascertaining the creditworthiness of rural small businesses can pose a number of challenges, not the least of which is that many rural small businesses are hard-information deficient. Rural small businesses are less likely than their urban peers to have audited financial statements, further reducing the amount and usefulness of hard information about their creditworthiness.⁸

Furthermore, community banks play a critical role in supporting local economies and civic groups in many rural and micropolitan areas that have fewer banking alternatives. In 2012, community banks were the only banks operating in 615 counties in the U.S. According to a 2014 study, “more than one-third of U.S. counties, with a total

⁶ Lux & Greene, pg. 2, 6-7.

⁷ Hester Peirce, Ian Robinson & Thomas Stratmann, “How Are Small Banks Faring Under Dodd-Frank?” Mercatus Center, George Mason University, February 2014, pg. 12.

⁸ Robert DeYoung, Dennis Glennon, Peter Nigro & Kenneth Spong, “Small Business Lending and Social Capital: Are Rural Relationships Different?” University of Kansas, Center for Banking Excellence, June 2012, pg. 2.

population of over 16 million people, would have limited physical access to mainstream banking services without the presence of a community bank.”⁹

History

The Financial Crisis & Lack of New Bank Entry

The financial crisis of 2008 had a profound effect on the commercial banking sector. According to the Federal Reserve Bank of Richmond, the number of commercial banks shrank by 14 percent, over 800 institutions, between 2007—2013. Most of the reduction was concentrated in the community banking sector where 839 institutions under \$1 billion in assets or 32.9 percent of the marketplace disappeared.¹⁰ The research shows that while some of the decline can be attributed to bank failures the majority of it is due to the collapse of new bank formation. Entry into banking during this time frame, commonly referred to as *de novo* activity, had been virtually nonexistent as there were only six banks chartered from 2011 through 2015 with zero new charters in 2012 and 2014. From a historical perspective, the only other period where *de novo* activity was similarly as stagnant was 1993-94 where 28 and 25 new banks were chartered respectively.¹¹

⁹ Arthur E. Wilmarth, “A Two-Tiered System of Regulation is Needed to Preserve the Viability of Community Banks and Reduce the Risks of Megabanks,” GWU Law School Public Research Paper No. 2014-53, 2014, pg. 290.

¹⁰ Roisin McCord & Edward Simpson Prescott, “The Financial Crisis, the Collapse of Bank Entry, and Changes in the Size Distribution of Banks,” Economic Quarterly, Federal Reserve Bank of Richmond, First Quarter 2014, pg. 30.

¹¹ Roisin McCord, Edward Simpson Prescott, and Tim Sabik, “Explaining the Decline in the Number of Banks Since the Great Recession,” Economic Brief, Federal Reserve Bank of Richmond, March 2015.

The Financial Crisis – Community Bank Experience¹²

YEAR	2008	2009	2010	2011	2012	2013	2014	2015*
# of Institutions**	8,305	8,012	7,658	7,357	7,083	6,812	6,509	6,182
Mergers	293	179	197	196	208	232	273	305
Failures	25	140	157	92	51	24	18	8
<i>De Novo</i> Charters	98	31	11	3	0	2	0	1
Problem Bank List	252	702	884	813	651	467	291	183

*as of Sept. 30th

**includes commercial banks and savings institutions

The lack of new bank formation during this timeframe may be traced to a deliberative attempt by the FDIC to increase capital and examination requirements on *de novo* banks that may have discouraged investors from forming new banks. According to an August 2009 Financial Institution Letter (FIL) from the FDIC to the banking industry, “Under current policy, newly insured FDIC-supervised institutions are subject to higher capital requirements and more frequent examination activities during the first three years of operation. The FDIC is extending its procedures for these institutions from three to seven years.”¹³ While the FDIC did indicate in a November 2014 FIL that they would return to the practice of three years of capital planning and heightened examination scrutiny they were careful to maintain complete discretion to go beyond the three years of planning should they deem it necessary. According to this FIL, five years after the 2009 letter, “the FDIC may seek a higher level of capital for those proposals displaying

¹² FDIC, “Statistics at a Glance,” September 30, 2015.

¹³ Federal Deposit Insurance Corporation, “Enhanced Supervisory Procedures For Newly Insured FDIC-Supervised Depository Institutions,” Financial Institutions Letter, FIL-50-2009, August 28, 2009.

heightened risk profiles or complexity, such as with respect the proposed institution's anticipated size, complexity, and business strategy.”¹⁴

In addition to the financial crisis of 2008, the evolution of branching laws in the U.S. may have served to increase industry consolidation as well as the legal and regulatory requirements that limited the size and number of banks were gradually eliminated over time. As far back as 1960, banks were not allowed to branch across state lines. In 1966, Congress amended the Bank Holding Company Act of 1956 allowing interstate banking only within states that expressly permitted it. However, interstate banking was not acted upon until 1978 when Maine allowed out-of-state bank holding companies the ability to operate within the state.¹⁵ The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) effectively knocked down the remaining barriers to interstate banking. After Riegle-Neal became law, the Federal Reserve Bank of Richmond found an increase in consolidation as stronger, larger banks acquired smaller, weaker ones to take advantage of economies of scale. As a result, the number of commercial banks fell to less than 7,000 institutions by the year 2000.¹⁶ Steady industry consolidations continues today.

The Legislative Response to the Financial Crisis

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank is widely considered to

¹⁴ Federal Deposit Insurance Corporation, “Guidance Related to the FDIC Statement of Policy on Applications for Deposit Insurance,” Financial Institutions Letter, FIL-56-2014, November 20, 2014.

¹⁵ Hubert P. Janicki & Edward Simpson Prescott, “Changes in the size Distribution of U.S. banks: 1960-2005,” Federal Reserve Bank of Richmond, Economic Quarterly, Fall 2006, pg. 296.

¹⁶ McCord, Prescott & Sabik, pg. 2.

be one of the most sweeping and expansive pieces of legislation ever enacted on the financial sector. According to the Federal Reserve Bank of Philadelphia's 2010 *Annual Report*, "Congress passed the law to improve accountability and transparency in the financial system and to protect consumers and investors from abusive practices in response to the worst financial crisis since the Great Depression."¹⁷ Another summary of the law created shortly after enactment characterized the Act as:

Massive and far-reaching financial reform legislation that will have a major and lasting impact on the financial condition and operations of US banks, nonbank financial institutions, and non-US banking organizations and other financial services organizations doing business in the United States.¹⁸

Among the various sweeping reforms of the law, Dodd-Frank created a new regime in charge of monitoring the financial stability of the largest and most interconnected financial institutions; it formed a framework for unwinding these banks should they falter; and, perhaps most important to the community banking sector, it established the Consumer Financial Protection Bureau (CFPB) to oversee consumer protections regarding financial products.¹⁹ Specifically, Dodd-Frank charged the CFPB with ensuring that consumers are provided with timely and understandable information so they can make informed and responsible financial decisions; protecting consumers from unfair, deceptive or abusive acts and practices; ensuring that financial services providers are following federal consumer financial law as well as taking appropriate enforcement

¹⁷ Federal Reserve Bank of Philadelphia, "Making History: Regulatory Reform Enacted," 2010 Annual Report, pg. 1.

¹⁸ Meyer Brown, "Understanding the New Financial Reform Legislation: The Dodd-Frank Wall Street Reform and Consumer Protection Act," July 2010, pg. 2.

¹⁹ *Ibid.*

actions against violators.²⁰ Several of the new rules and regulations promulgated by the CFPB cause considerable consternation in the community banking sector today.

It is important to note that Dodd-Frank exempts banks under \$10 billion in assets (i.e. community banks) from a number of provisions, not the least of which is an exemption from examination and enforcement by the CFPB. While banks of all sizes are required to comply with new CFPB rules, the CFPB itself does not examine community banks under \$10 billion in assets. Compliance examinations remain with the banks' prudential regulator. While noting these exemptions, a recent GAO Report stated, "However, the act is comprehensive and far-reaching and includes many provisions that impose additional requirements on small insured depository institutions."²¹

The Impact of the Financial Crisis on Small Business

The financial crisis hit small businesses particularly hard as community bank capital dried up and became less available to the firms that rely on it most. According to a recent working paper by former U.S. Small Business Administration Administrator Karen Gordon Mills:

Small firms are always hit harder during financial crisis because they are more dependent on bank capital to fund their growth. Credit markets act as a "financial accelerator" for small firms, such that they feel the credit market swings up and down more acutely.²²

²⁰ Government Accountability Office, "Dodd-Frank Regulations: Impacts on Community Banks, Credit Unions and Systemically Important Institutions," December 2015, pg. 10.

²¹ *Ibid*, pg. 12.

²² Karen Gordon Mills & Brayden McCarthy, "The State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game," Harvard Business School, July 22, 2014, pg. 3.

Since 1995, small businesses have created two out of every three jobs in the United States. Between 2007 and 2012, the small business share of total job loss was about 60 percent with the smallest firms, those with fewer than 50 employees, suffering the greatest losses. Small businesses are back to creating two out of every three net new jobs but there remains a significant gap.²³

Despite economic crises and steady industry consolidation, community banks remain prolific small business lenders in the United States. In the decade prior to the financial crisis (1998-2008) community bank lending to small businesses doubled in volume. In 2000, community banks were responsible for 57 percent of all small business lending. That number stands at 51 percent today.²⁴

Background

Industry Consolidation & Harm to Consumers

According to numerous press reports and academic articles written over the last several years, the financial crisis of 2008 along with the passage of Dodd-Frank has exacerbated the decline of the community banking sector as banks continue to merge and consolidate out of existence. The issue of consolidation is compounded by the lack of new bank formation, or *de novo* activity, as new banks are not formed at a steady enough rate to replenish the “stock” of banks lost through merger. A recent *American Banker* article stated:

More recently, the lack of new banking charters is playing a big role – as banks continue to merge and close, there’s been little influx of new institutions to

²³ Mills & McCarthy, pg. 3.

²⁴ Lux & Greene, pg. 11-12.

balance that out. That's a critical factor to consider when looking at the decline in the number of banks over the past several years.²⁵

The Federal Reserve Bank of Richmond finds that new-bank formation has fallen from an average of about 100 per year since 1990 to an average of about three per year since 2010. The decline in new bank entry disproportionately impacts community banks as new banks start small.²⁶ According to recent FDIC data, the number of commercial banks and savings institutions has decreased from 8,305 in 2008 to 6,182 as of September 30, 2015. Over this period, 1,883 institutions merged with other banks while 515 failed.²⁷ The decrease in the overall number of community banks coupled with the fact that only six *de novo* banks were chartered between 2011 and 2015, with zero in 2012 and 2014, is cause for alarm in the community banking sector. This timeframe captures the worst of the financial crisis, the passage of Dodd-Frank, as well as implementation of many of the Act's regulations that financial institutions — particularly community banks — still wrestle with today.

If the community banking sector continues to consolidate and lose market share at the current rate and if there continues to be a lack of new entrants to replenish the “stock” of community banks lost to failure or merger many individual borrowers, farmers and small businesses will be harmed as they search to replicate the lending expertise historically demonstrated by the community banking sector but may face fewer and less attractive borrowing options. For example, default rates for residential mortgages held in a banks' portfolio were much higher for larger institutions than community banks

²⁵ Finkle, “Is Dodd-Frank Really Killing Community Banks?”

²⁶ McCord, Prescott & Sabik.

²⁷ FDIC, “Statistics at a Glance,” September 30, 2015.

between 2003 and 2012 demonstrating community banks' ability to match their customers with residential mortgage products that work best for them.²⁸

In regards to rural lending, a study examining 18,000 Small Business Administration (SBA) loans made by both rural and urban banks found that small business loans made by rural community banks defaulted much less often than those originated by urban banks.²⁹ This is crucial when considering that community banks are often the sole banking center in many rural areas as more than one-third of U.S. counties, representing over 16 million people, would have limited physical access to mainstream banking services if not for their local community bank.³⁰ Concerning small business lending:

Bank credit, particularly through term loans, is one of the primary sources of external financing for small businesses — especially Main Street firms — and is key to helping small firms maintain cash flow, hire new employees, purchase new inventory or equipment, and grow their business.³¹

Historically, large banks have cut back on small business lending during financial crises. For example, Bank of America's small business lending contracted from \$25 billion in 2006 to \$12 billion in 2014 while Wells Fargo's decreased from \$45 billion in 2007 to less than \$25 billion in 2014.³² Conversely, small business lending at community banks slightly increased during roughly the same timeframe even though the share of

²⁸ Lux & Greene, pg. 2, 6-7.

²⁹ DeYoung, Glennon, Nigro & Spong, pg. 22.

³⁰ Wilmarth, pg. 290.

³¹ Mills & McCarthy, pg. 4.

³² Kevin Wack, "Small Businesses Are Unhappy With Online Lenders," American Banker, March 3, 2016.

total assets at community banks declined. Furthermore, small business lending by community banks grew at a faster clip in 2013 and 2014 than larger banks.³³

While other firms may be able to meet some of the credit needs of America's mortgage seekers, rural borrowers and small businesses, the loan products may be less safe, the terms less favorable and the customer experience less satisfying than at a community bank.

Regulatory Burden on Community Banks

Anecdotal evidence indicates that community banks have a difficult time navigating the new rules and regulations imposed upon them in the post-financial crisis world. Many community banks lack the expertise and financial resources necessary to ensure compliance while absorbing increased regulatory costs. According to a recent study discussing the difficulty community banks have with new regulations:

Our findings suggest that Dodd-Frank has deeply affected small banks. They are spending more time and money on compliance and, in some cases, are shifting away from products, such as residential mortgage loans, for which the regulatory burden appears to outweigh the benefits of continued involvement.³⁴

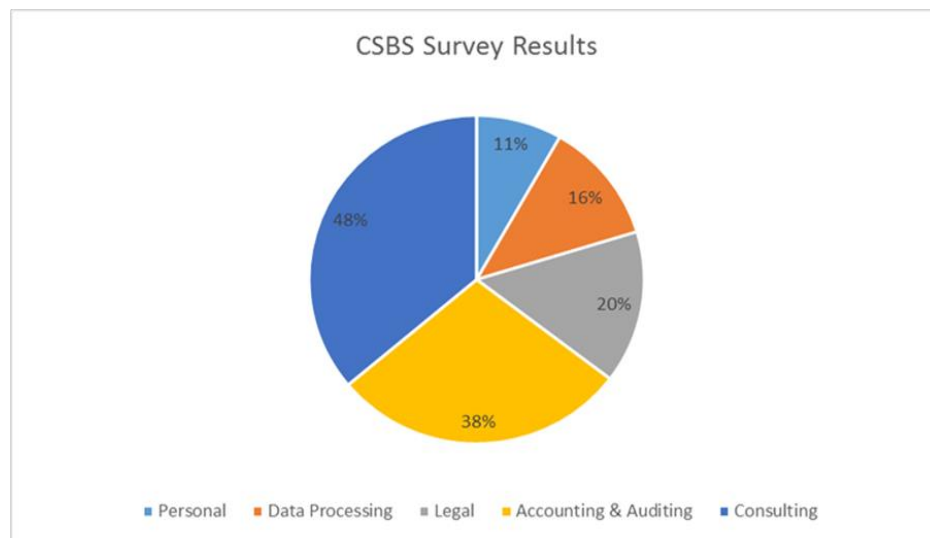
Survey data shows that nearly 90 percent of responding community bankers reported an increase in compliance costs with 82.9 percent reporting an increase of over five percent from the previous year.³⁵ According to a 2015 survey conducted by the Conference of State Bank Supervisors (CSBS), regulatory compliance accounted for 11

³³ Wilmarth, pg. 293.

³⁴ Pierce, Robinson and Stratmann, pg. 12.

³⁵ *Ibid*, pg. 34.

percent of personal expenses, 16 percent of data processing expenses, 20 percent of legal expenses, 38 percent of accounting and auditing expenses and 48 percent of consulting expenses. From the survey, “To the extent that these percentages are accurate and representative of the community banking industry, they imply a hypothetical compliance cost to community banks, in these areas alone, of \$4.5 billion annually. This would represent 22 percent of their net income.”³⁶



Several of these new rules stem from the CFPB. One survey reported that 37 percent of community bank respondents reported hiring additional compliance staff in response to CFPB-specific rules. One CFPB rule that vexes community bankers is the Qualified Mortgage (QM) rule. The QM rule imposes rigorous standards of proof on the lender to assure that the loan is not needlessly risky in addition to extensive documentation of the borrower’s ability to repay the loan. If the loan is deemed QM, then the lender will receive certain protections against lawsuits brought by the borrower and

³⁶ Conference of State Bank Supervisors, “Community Banking in the 21st Century,” Annual Community Bank Research and Policy Conference, September 30-Oct. 1, 2015, pg. 11.

protections against their ability to avoid foreclosure.³⁷ According to a 2015 survey, “66 percent of respondents said they do not provide loans that are outside the Consumer Financial Protection Bureau’s Qualified Mortgage definition or would only do so in special cases.”³⁸

One community banker noted in his survey response, “This piece of regulation is written so unclearly with so many trip wires that serve no benefit to customers, that we anticipate not offering a mortgage product.”³⁹ Another respondent noted, “All the uncertainty and changing in definitions related to qualified mortgages, mortgage banking requirements and so forth has made the business of serving customers by helping them become homeowners much more difficult, cumbersome and time consuming.”⁴⁰

While new CFPB mortgage rules are a convenient target for bankers’ ire they are not the only regulatory “pain point” for community banks. Many community bankers struggle with new capital requirements as part of Basel III. Basel III is an international agreement originally designed to strengthen capital levels at the largest and most globally interconnected financial institutions but applies to community banks in the United States as well. Community bankers also struggle with the increased burden from filing the quarterly Call Report that has grown exponentially over the years as well as the frequency and duration of compliance examinations.

³⁷ James DiSalvo & Ryan Johnston, “Banking Trends, How Dodd-Frank Affects Small Bank Costs,” Federal Reserve Bank of Philadelphia, First Quarter 2016, pg. 14-15.

³⁸ Independent Community Bankers of America, “2014 ICBA Community Bank Lending Survey,” Executive Summary, January 2015.

³⁹ Pierce, Robinson and Stratmann, pg. 49.

⁴⁰ *Ibid*, pg. 52.

Online Marketplace Lenders

One area in need of discussion when considering the future of community banking is the emergence of online marketplace lenders such as OnDeck Capital, Kabbage and Lending Club. According to a recent article in *Forbes*, Kabbage offers prospective borrowers with lines of credit up to \$100,000 payable over 6 months. The average line of credit is \$25,000 and the average borrower takes 6 to 8 loans a year totaling \$50,000. Note that the annual percentage rate (APR) of these loans can be upwards of 27 percent, much higher than the typical APR offered by a more traditional lender. Kabbage is reported to keep their default rate low by targeting established businesses using an automated lending model that assesses capacity to repay, the character of the borrower, and the consistency or stability of the business.⁴¹

While this model may work for the smallest firms that become habitual borrowers of short-term credit, many small businesses still fall outside of “model-based” marketplace lending. This further demonstrates the continued importance of community bank lending in this space. According to a recent study:

Small banks can fill a niche stemming from their ability either to successfully lend to what have been variously described as ‘informationally opaque’ borrowers—borrowers without long credit histories suitable for credit-scoring or other model based lending practices.⁴²

Additionally, it is unclear if online marketplace lenders would continue to lend to small businesses in an economic downturn, such as the recent Great Recession.

⁴¹ Darren Dahl, “The Six-Minute Loan: How Kabbage Is Upending Small Business Lending -- And Building A Very Big Business,” *Forbes*, May 6, 2015.

⁴² Pierce, Robinson & Stratmann, pg. 12.

According to one study, “In keeping with their business strategy of building strong relationships, community banks proved to be more reliable sources of credit to small businesses during the last two banking crises, compared with larger banks.”⁴³ It remains to be seen if online marketplace lenders will continue to lend during a similar crisis or if they will have the ability or capacity to perform loan modifications or “workouts” with their borrowers should they default on a payment. While it appears that online marketplace lending will proliferate over the next several years, it is not clear if they will continue to provide credit to their customers, as community banks have done, in an historic economic downturn.

Furthermore, a recent small business credit survey conducted by the Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond and St. Louis found the overwhelming majority of small business borrowers that worked with online marketplace lenders were dissatisfied with their experience. The survey found that online lenders received a satisfaction score of only 15 out of 100, far lower than community banks that received a satisfaction score of 75.⁴⁴ One of the authors of the survey stated, “The two most common reasons that successful applicants cited for their dissatisfaction with online lenders were high interest rates and unfavorable repayment terms, a catchall category that could include prepayment penalties.”⁴⁵ This further demonstrates the harm caused to individual small businesses should community banks continue to consolidate and exit the marketplace.

⁴³ Wilmarth, pg. 292.

⁴⁴ Claire Kramer Mills, PhD, “2015 Small Business Credit Survey, Report on Employer Firms,” Federal Reserve Banks of New York, Atlanta, Boston, Cleveland, Philadelphia, Richmond & St. Louis, March 2016, pg. iii.

⁴⁵ Wack, “Small Businesses Are Unhappy With Online Lenders.”

Key Policymakers

Several policymakers representing the prudential regulatory agencies have publicly called for some level of regulatory relief for community banks. While addressing an annual conference Federal Reserve System Chair Janet Yellen stated:

When it comes to bank regulation and supervision, one size does not fit all. To effectively promote safety and soundness and ensure consumer compliance without creating undue regulatory burden, rules and supervisory approaches should be tailored to different types of institutions... The Federal Reserve is committed to this approach of community bank oversight and to ensure that new and existing regulations are not unduly burdensome for community banks.⁴⁶

FDIC Vice Chairman Thomas M. Hoenig supports relief for banks, especially community banks, that adhere to a safer and less complex business model. According to Hoenig, “For the vast majority of commercial banks that stick to traditional banking activities and conduct their activities in a safe and sound manner with sufficient capital reserves, the regulatory burden should be eased.”⁴⁷ Current Senate Banking Committee Chairman Richard Shelby (R-AL) as well as Ranking Member Sherrod Brown (D-OH) have also shown support for the community banking sector. Unfortunately, their varying proposals to provide community banks with regulatory relief have been nullified due to differing political ideologies. According to a recent *American Banker* article, “Washington is unlikely to reach compromise over regulatory relief for community banks anytime soon. That’s because the battle over regulatory relief is not about politics. It’s

⁴⁶ Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, Community Banking in the 21st Century,” The Third Annual Community Bank Research and Policy Conference, September 30, 2015, pg. 3-4.

⁴⁷ Gretchen Morgenson, “Regulatory Relief for Banks That Rarely Fail,” The New York Times, April 18, 2015.

about ideology.”⁴⁸ The political “right” represented by Chairman Shelby and others is calling for less government intervention in the banking sector while the political “left” supported by Sens. Brown and Elizabeth Warren (D-MA) view banking services as a public utility that should be devoid of risk and more widely available to the average consumer. Unfortunately, community banks appear to be caught in the middle of this ideological battle.

Policy Proposal

Policy Authorization Tool

The Independent Community Bankers of America (the Association) should support Federal legislation to amend Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) in an effort to provide targeted regulatory relief for banks that adhere to traditional banking characteristics based on activity and complexity, not merely size. This legislation is based on but not identical to the “Hoenig Proposal” as offered by FDIC Vice Chairman Thomas M. Hoenig.⁴⁹ According to the proposal, banks that hold 10 percent tier one equity capital, refrain from trading and limit their derivatives exposure would be eligible for significant regulatory relief. This relief would include exemptions from certain mortgage rules, new capital requirements, as well as be eligible to file a short form call report and benefit from an expanded examination cycle.

⁴⁸ Richard J. Parsons, “Warring Ideologies Dash Small Banks’ Hopes for Reg Relief,” *American Banker*, September 25, 2005.

⁴⁹ Thomas Hoenig, Vice Chairman, Federal Deposit Insurance Corporation, “A Conversation about Regulatory Relief and the Community Bank,” 24th Annual Hyman P. Minsky Conference, National Press Club, April 15, 2015.

Additionally, the Association should encourage the FDIC to issue supplemental guidance reaffirming its intention to administer the policies of Part 303 of the FDIC's Rules and Regulations (12 U.S.C. 1815) subjecting newly insured depository institutions to three years of capital and business planning requirements and more frequent examinations as opposed to seven years.⁵⁰ This would augment the "Questions & Answers" document of November 2014 that left the FDIC with considerable discretion to go above and beyond the three year requirements if deemed appropriate.⁵¹ In order to encourage investment into new bank formation the FDIC should issue more definitive guidance to effectively nullify their August 2009 policy requiring seven years of planning and heightened examinations.⁵²

Policy Implementation Tool

Banks that meet the following criteria would be eligible for regulatory relief:

- Hold 10 percent tier one equity capital;
- Hold effectively zero trading assets or liabilities;
- Hold no derivative positions other than interest rate swaps and foreign exchange derivatives
- Have less than \$3 billion in total notional value of all derivatives exposure.

⁵⁰ Federal Deposit Insurance Corporation, "DSC Risk Management Manual of Examination Policies," accessed on 3/10/16: <https://www.fdic.gov/regulations/safety/manual/section12-1.pdf>.

⁵¹ FDIC, Financial Institutions Letter, FIL-56-2014, November 20, 2014.

⁵² FDIC, Financial Institutions Letter, FIL-50-2009, August 28, 2009.

Regulatory relief provisions for eligible institutions include:

- Automatic Qualified Mortgage (QM) status for all mortgage loans held in a bank's portfolio;
- Exemption from certain Basel III capital rules, such as the capital conservation buffer;
- Use of a short form Call Report to be developed by the prudential regulators;
- Eligible for a 24-month examination cycle.⁵³

In regards to encouraging investment into new bank charters, the FDIC has the statutory authority – under Part 303 of their Rules and Regulations (12 U.S.C. 1815) – to administer guidance to clarify their policies of subjecting newly insured depository institutions to three years of planning and more frequent examinations as opposed to seven years.

Policy Analysis

Strengths of the Modified Hoenig Proposal

The modified version of the Hoenig proposal would provide meaningful targeted regulatory relief to the vast majority of commercial banks. According to Hoenig, only 400 of the nation's 6,000 plus banks would not meet the criteria to receive regulatory relief and zero banks over \$100 billion in total assets would qualify. Furthermore, only 90 of the 4,000 banks with less than \$250 million in total assets would fail to qualify.⁵⁴

⁵³ These regulatory relief provisions closely mirror but are not identical to those proposed by FDIC Vice Chairman Thomas M. Hoenig.

⁵⁴ Hoenig, "A Conversation about Regulatory Relief and the Community Bank."

Validating the effectiveness of the Hoenig proposal, *The New York Times* financial services reporter Gretchen Morgenson said, “It actually outlines smart ways to give regulatory relief only to low-risk, traditional banks that did not cause the financial crisis. Those institutions that did contribute to the 2008 mess get no relief under the plan.”⁵⁵

One of the key elements of the plan is to incentivize banks to hold higher levels of tier one equity capital as it is the most effective capital a financial institution can deploy during a financial crisis to remain solvent. According to Anat Admati and Martin Hellwig who authored the book entitled *The Bankers’ New Clothes, What’s Wrong with Banking and What to Do about It*, there are several advantages to banks holding more equity capital. Namely, more equity would reduce the likelihood that a bank would fail or dissolve in an economic crisis leading to an overall safer and more stable financial system. Banks with more equity financing and less debt are known to make better loans where highly indebted banks are prone to taking excessive risks and banks that can withstand economic volatility are in a better position to lend during a crisis.⁵⁶

Another key benefit is the meaningful regulatory relief gained by meeting the requisite criteria. As mentioned above, community banks are struggling with certain rules and regulations. One example being the new Qualified Mortgage or QM standard for residential mortgage loans. If banks meet the appropriate criteria, they would be allowed to consider all mortgage loans held in portfolio as “qualified mortgages” thus limiting their litigation risk should the borrower default. During the financial crisis and

⁵⁵ Morgenson, “Regulatory Relief for Banks That Rarely Fail.”

⁵⁶ Anat Admati & Martin Hellwig, “The Bankers’ New Clothes, What’s Wrong with Banking and What to Do about It,” Princeton University Press, 2013, pg. 220.

subsequent legislative battle, then House Financial Services Committee Chairman Barney Frank (D-MA) referred to a concept he called “skin in the game” where a lender would be required to hold at least 5 percent of a loan on their books in order to encourage prudent responsible lending. According to Frank:

If I can make a whole bunch of loans and sell the entire right to collect those to somebody else, at that point I don't care...whether or not they pay off. We have to prohibit that. We're basically saying now, 'You've got to keep 5 percent of that.' So that if there are losses, you lose money, too.⁵⁷

Automatic QM status for loans that remain on the banks’ books where the lender retains 100 percent of the risk is the ultimate version of “skin in the game.” A recent study by the Housing Finance Policy Center revealed that portfolio loans – those that are held on a lender’s balance sheet – accounted for roughly 27 percent of total originations in 2014, the highest level in a decade.⁵⁸

In regards to Basel III, the prudential banking regulators plan on applying it to all bank charters in the U.S. regardless of size or business model. One summary of the rule found:

Basel III is the most complete overhaul of U.S. bank capital standards in nearly a quarter of a century. It comprehensively revises the regulatory capital framework for the entire U.S. banking sector and will have significant implications for community banks from a business, operations, M&A and regulatory compliance perspective.⁵⁹

⁵⁷ Chris Arnold, “Forcing Banks to Put More 'Skin in The Game,’” National Public Radio, June 18, 2009.

⁵⁸ Karan Kaul, “What’s behind the growing share of bank portfolio lending?” Urban Wire, Housing and Housing Finance, March 18, 2015.

⁵⁹ Luigi De Ghenghi & Andrew S. Fei, “Basel III: Guide for Community Banks,” Davis Polk & Wardwell LLP, October 2013.

While some concessions were eventually made for community banks, they are still required to comply with many of the complex capital rules and calculations of Basel III. One concession being a provision that will no longer allow banks to consider mortgage servicing assets (MSAs) as common equity capital.⁶⁰ Requirements such as the new capital treatment of MSAs are overly burdensome and costly to community banks. Appearing before a congressional committee, one community banker testified that the MSA provision of Basel III would cost his \$270 million community bank over \$1.6 million in common equity tier one capital, reducing their tier one ratio by 50 basis points.⁶¹ Exempting banks that meet the appropriate criteria from certain Basel III capital requirements would allow them to focus key resources on lending in their communities or fortifying their balance sheet.

Community bankers have become increasingly concerned with the growing burden of filing their quarterly Call Report, officially known as the Reports of Condition and Income. A 2014 survey found strong evidence that the current call reporting requirements for community banks are an ever-increasing burden on their ability to serve their customers. According to the survey, “Community banks are increasingly forced to complete more and more schedules to comply with increased regulation without regards to the size of the institution or the resources available to the community bank to meet reporting obligations.” Furthermore, nearly three quarters of survey respondents indicated that a short form call report would reduce their regulatory burden significantly.⁶³

⁶⁰ *Ibid.*

⁶¹ Samuel A. Vallandingham, “Examining Regulatory Relief Proposals for Community Financial Institutions, Part II,” Testimony before the Committee on Financial Services Subcommittee on Financial Institutions and Consumer Credit, July 15, 2014.

⁶³ Independent Community Bankers of America, “2014 ICBA Community Bank Call Report Burden Survey,” undated.

In regards to an extended examination cycle, the original Hoenig proposal calls for an 18-month cycle for highly rated banks. The modified version calls for a 24-month cycle. This provision follows recent action by the prudential banking regulators to allow highly rated banks with less than \$1 billion in assets to qualify for an 18-month examination cycle. According to the Federal Reserve, an additional 617 banks would qualify for less frequent exams.⁶⁴ The plan recommended above would allow a greater number of highly rated banks to take advantage of an even longer cycle.

Finally, in order to address the lack of new bank formation, the FDIC should issue guidance to further clarify and relax their capital and business planning and heightened examination requirements on *de novo* banks. As earlier noted, new bank formation has stalled in recent years as only six banks were chartered from 2011 through 2015 with no new charters in 2012 and 2014. This lack of activity is unprecedented. Calling for further clarity from the FDIC may help spur investment in chartering *de novo* banks that will help replenish the “stock” of community banks lost to failure and consolidation since the Great Recession.

Weaknesses of the Modified Hoenig Proposal

The capital markets are highly competitive and it is difficult for many community banks, particularly those in rural or economically depressed areas, to raise outside capital. Since the criteria to be eligible for regulatory relief is tied to a tier one equity capital level of 10 percent, this proposal could potentially exclude a number of community banks that simply cannot raise the requisite funds necessary to qualify for relief. For those

⁶⁴ John Heltman, “More Banks to Qualify for 18-Month Examination Cycle Under New Rule,” *American Banker*, February 19, 2016.

individuals and organizations that would like to increase regulatory requirements on banks, the purposeful exclusion of a wide swath of banks could be viewed as a key feature of the proposal and not a weakness. Taking that under consideration, the higher bar for inclusion should be viewed as a negative consequence for the Association charged with promoting the policy needs of the community banking sector at large. Supporting higher capital levels could potentially disenfranchise a number of community banks that simply cannot meet the new requirements.

Furthermore, the procyclical nature of the relief provisions would decrease the number of institutions eligible to take advantage of them during an economic downturn as the added regulatory burdens would hit community banks at the absolute worst time. For example, if an individual banks' tier one equity capital were to dip below 10 percent, their residential loan portfolio would become subject to the QM rule, they would have to comply with all of the capital requirements of Basel III and would no longer be able to take advantage of the short form call report or extended examination cycle.

Additionally, an easing of FDIC *de novo* requirements for new bank charters may increase the number of bank failures during a financial crisis as new charters are known to fail in greater numbers, particularly after year three. According to the FDIC, "Depository institutions insured less than seven years are overly represented on the list of institutions that failed during 2008 and 2009, with most of these failures occurring between the fourth and seventh years of operation."⁶⁵ In the run-up to the financial crisis, many of these institutions grew rapidly and were not prepared from a capital or management perspective to address the historic decline in the value of both commercial

⁶⁵ FDIC, Financial Institutions Letter, FIL-50-2009, August 28, 2009.

and residential real estate.⁶⁶ When those values declined, some banks were left without enough capital to weather the storm. The increased number of bank failures puts added stress on the Deposit Insurance Fund (DIF) during a crisis and will lead to special deposit insurance assessments to be paid by all banks to restore the DIF.

Political Analysis

In order to advance a modified version of the Hoenig proposal, it is critical to gain bipartisan support from key members of Congress, particularly those on the House Financial Services and Senate Banking Committees. Fortunately, House Financial Services Committee Chairman Jeb Hensarling (R-TX) has been an outspoken advocate for community bank regulatory relief and recently declared his intention to advance his own version of the proposal. According to a recent *American Banker* article:

Republicans were "deep into our planning" about an alternative reform bill, outlining several components. The chief one is allowing banks to be released from certain Dodd-Frank and Basel III requirements if they hold higher capital. That idea was first suggested by Federal Deposit Insurance Corp. Vice Chairman Thomas Hoenig, who has argued that the current regulatory regime is too complex for most institutions.⁶⁷

Chairman Hensarling's declaration coincides with recent legislation introduced by Rep. Ed Perlmutter (D-CO), also a member of the House Financial Services Committee. Perlmutter's bill, similar to the Hoenig proposal, would provide targeted regulatory relief

⁶⁶ Michael Shumaker, "Is The Time Right for De Novo Banks?" BankDirector.com, January 23, 2015.

⁶⁷ Ian McKendry, "Hensarling's 'Bold Alternative' for Reform Includes Big Capital Change," *American Banker*, March 15, 2016.

for banks that adhere to traditional banking characteristics based on activity and complexity, not merely size. According to a press release issued by the Congressman:

Community banks were not the cause of the financial crisis of 2007-2008, yet they are now forced to bear the burden and expense of complying with new regulatory requirements in place to prevent future crises. This legislation will help ease the regulatory burden for the vast majority of banks who engage in traditional banking activities and conduct their activities in a safe and sound manner.⁶⁸

In regards to the Senate, both Senate Banking Committee Chairman Richard Shelby (R-AL) and Ranking Member Sherrod Brown (D-OH) have been publicly supportive of regulatory relief for community banks. When discussing his own regulatory relief proposal, Shelby said:

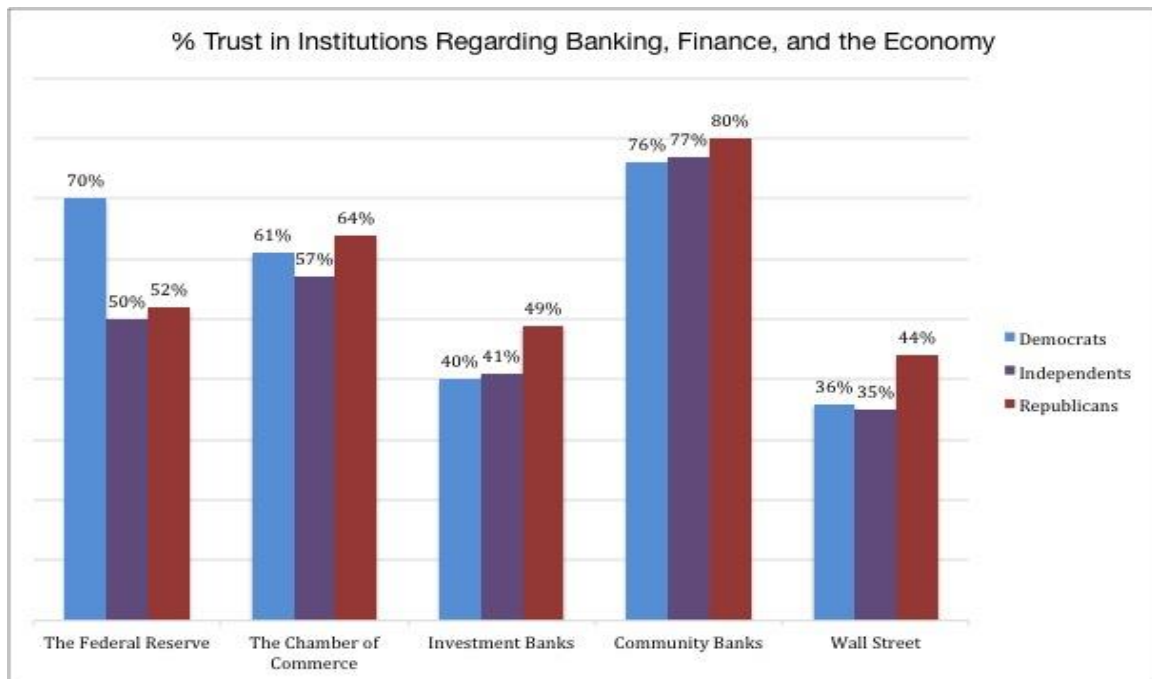
It goes without saying that these institutions – like the more than 150 community banks currently operating in Alabama – provide vital support to local economies, including the role they play in small business lending. That is why my legislation provides regulatory relief for community financial institutions that have been smothered with excessive regulations since the passage of Dodd-Frank.⁶⁹

For any regulatory relief legislation to pass the Senate it is crucial that the proposal be viewed as relief for community banks and not the largest banks as community banks remain politically popular and trusted among the general public. As demonstrated below, community banks maintain a higher percentage of trust regarding

⁶⁸ Ashley Verille, “Perlmutter Introduces Regulatory Relief Legislation for “Traditional Banks,” Helps community banks and other non-systemic banks struggling with increased regulatory burden and costs,” Press Release, February 26, 2016.

⁶⁹ U.S. Senator Richard Shelby, “It's time to fix Dodd-Frank's broken system,” AL.com, December 8, 2015.

banking, finance and the economy than Wall Street firms, investment companies and even the Federal Reserve.



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Furthermore, supporters of regulatory relief legislation will have to address opposition from Sen. Elizabeth Warren (D-MA) and Rep. Maxine Waters (D-CA), the current ranking member of the House Financial Services Committee, as both are outspoken critics of any legislative proposals that could potentially undermine the Wall Street reforms of the Dodd-Frank Act. At a recent Senate Banking Committee Hearing Warren said, “We should be very skeptical of regulatory relief bills that are promoted as helping small banks but that are pushed by ABA (American Bankers Association) lobbyists for the big banks.”⁷¹ According to *The Wall Street Journal*:

⁷⁰ Timothy R. Homan, “The Financial Crisis’ Long Hangover,” Morning Consult, July, 27, 2014.

⁷¹ Ryan Tracy, “Warren Throws Water on ‘Regulatory Relief’ for Small Banks,” *The Wall Street Journal*, February 13, 2015.

The hearing was the second this week on “regulatory relief” for community banks and credit unions. But Ms. Warren’s exchange with an ABA representative underscored the rocky road ahead for any legislation designed to provide that relief. If a bill backed by the Republican majority goes too far in changing Dodd-Frank, it might lose Democratic support.

To neutralize opposition from the Warren-Waters contingent, it is critical to secure bipartisan support from rank-and-file members of Congress as well as key stakeholders representing the financial regulatory community including Chair Janet Yellen and Governor Daniel Tarullo from the Federal Reserve, Chairman Martin J. Gruenberg and Vice Chairman Hoenig from the FDIC as well as Comptroller of the Currency Thomas J. Curry. Fortunately, all of the above have publicly demonstrated some level of interest in protecting and preserving the community bank charter. Establishing broad public, bipartisan support will be instrumental in the effort to advance regulatory relief for community banks.

One area of the proposal that will receive particular scrutiny and potential opposition is any effort to pressure the FDIC to relax their *de novo* policies. The FDIC itself is likely to push back against this as, in their view, they have already sufficiently clarified the three-year capital and business planning and heightened examination policies. To support their autonomy to go above and beyond the three-year planning requirements for certain new firms, the FDIC is likely to focus on data that exhibits an increase in the number of *de novo* failures between years four and seven during the financial crisis and the increased pressure these failures had on the Deposit Insurance Fund.

In their effort to influence FDIC policy, the Association will need to recruit sympathetic members of congress, particularly those on House Financial Services and Senate Banking, and urge them to exert their oversight authority to call for hearings into the lack of new bank formation since the Great Recession. Legislators can also circulate a *Dear Colleague* letter urging the FDIC to review and possibly amend their *de novo* chartering policies in addition to calling on the Government Accountability Office (GAO) to study the possible effects the lack of new bank formation has on the economy and job growth.

This approach does carry significant risk as industry advocates can exert some level of influence over the hearing process and the proposed GAO report but cannot control the outcomes of either. For instance, a GAO report or hearing may conclude that more *de novo* banks will be at greater risk of failure during a crisis putting too much pressure on the DIF, thus threatening the stability of the financial system. This could lead to special deposit insurance assessments in order to replenish the depleted insurance fund. The hearing and report could also conclude that there isn't significant interest from investors in forming new banks due to economic conditions caused by historically low interest rates. Also, this process allows critics of the banking sector at large, including consumer groups such as Americans for Financial Reform and the Center for Responsible Lending, to publicly criticize those advocating for policies that they perceive could put individual consumers and the greater financial system at risk.

Recommendation

If industry consolidation continues at the current rate without the benefit of new bank formation, a significant portion of residential mortgage seekers, rural borrowers and small businesses will be harmed as they are forced to look elsewhere for credit. While online marketplace lenders or the largest banks may be able to meet some of their credit needs, the loan products may be less safe, the terms less favorable and the customer experience less satisfying than at a community bank. In order to maintain optimal credit availability for these borrowers, policies should be advanced to preserve and protect the community bank charter.

One of the major benefits of the modified Hoenig proposal advocated above is its effectiveness in providing targeted regulatory relief to banks that need and deserve it most. Another key attribute is that it encourages banks to hold a higher percentage of tier one equity capital that engenders an overall safer and more stable financial system, better lending practices and a greater likelihood that banks will continue to lend in an economic downturn.

Furthermore, the proposal provides meaningful relief from some of the most burdensome regulations that bankers continue to struggle with today including the CFPB's Qualified Mortgage rule, the complex capital calculations of Basel III, as well as offering an extended examination cycle and short form call report for highly rated banks. These are tangible reforms that individual community bankers have been demanding since the passage of Dodd-Frank.

As the major drawback to the proposal, a number of community banks in rural or economically depressed areas will find it difficult to meet the 10 percent tier one capital

threshold. Moreover, banks that fall under the 10 percent threshold will see their regulatory burden increase dramatically. With that said, the meaningful relief provided for the majority of banks that struggle to comply with these regulations outweighs the reality that some will be left to deal with higher regulatory scrutiny. Furthermore, based on the popularity and high level of trust the general public has in the community banking sector, in addition to strong bipartisan support from lawmakers and the regulatory community, such a proposal is politically feasible. Therefore, it is recommended that the Association endorse the modified version of the Hoenig proposal and work to advance Federal legislation to enact it into law.

In regard to the lack of new bank formation, there is heightened risk to the community banking sector and the Association by publically pressuring the FDIC to embrace less strict capital and business planning and examination requirements for *de novo* banks. The FDIC itself is likely to oppose such efforts as it increases the risk to the Deposit Insurance Fund and arguably the greater economy. Therefore, it is recommended that the Association not directly pressure the FDIC to embrace less strict requirements. In lieu of this suggestion, it is recommended that the Association work with concerned policymakers to pursue a congressional hearing to focus on the lack of new bank formation. A hearing will help raise the profile of this issue while falling short of making specific demands of the FDIC to relax their chartering policies.

Curriculum Vitae

Aaron Stetter is a native of Buffalo, N.Y. and now lives in Washington, D.C. with his wife. Stetter earned his bachelor of arts in English and Political Science from the State University New York at Buffalo in 2001. Currently, Aaron is senior vice president of congressional relations and advocacy for the Independent Community Bankers of America® where he advocates the association's policy positions before members of Congress, financial regulatory agencies and the executive branch.